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Analysis Of Credit Risk in Legal Entities in The Case of „Vakufska Banka" – Sarajevo

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Abstract

Each bank in its operations, faces numerous factors that can lead to negative consequences. Risk represents the uncertainty of future outcomes, which consists of uncertainties and exposure to the specified uncertainty. If the bank is exposed to uncertainty it can lead to serious financial consequences, provided that the level of uncertainty is not equated with the degree of exposure. It should be noted that most of the risks can not be predicted and financial institutions over and over again are facing with crisis phenomena and numerous losses because they do not have accompanying measures and strategies to combat the risks. The subject of the final paper is related to the definition and analysis of credit risk management. In accordance with a defined problem and the subject of research, the main goals are to define the main banking risks as well as the Basel principles and risk management strategy, define credit risk, analyze credit risk management in banking and to analyze and present credit risk management in legal entities in the example of the "Vakufska banka" (analysis of qualitative and quantitative indicators, cash flow analysis, analysis projects, the SC analysis, exposure, analysis of related parties).

JEL Classification codes : G2, G1.

Keywords: risk management, legal entities, credit risk, banking.

Introduction

Each banking business meets certain kind of risk that affects the operation of banks and other companies or organizations. It is important to know that list of risks is not always the same. It changes with the application of new tools, techniques and strategies as well as new products and special financial derivatives. The risk is identified with that state in which there is a possibility of occurrence of adverse events. Banking operations recognizes a large number of risks, among which the most important are liquidity risk, credit risk, interest rate risk and currency risk.

The economic crisis in the world have caused the emergence of a scientific discipline called risk management. Risk management involves a series of steps such as identification, measurement, monitoring and risk control. Each of these steps is aimed to completely remove or mitigate the negative effects caused by the risks.

Credit risk is the main risk that occurs during the bank operations. Today, credit risk management is considered as significant activity of each financial institution. Specifically, this risk prevents the debtor to return the approved loan to the bank at any given time, together with accrued interest. Also, upon the occurrence of this type of risk bank profit is reduced because the borrower fails to fulfill its obligations under the matured debt (principal and interest).

During recent years, the scope and application of techniques and instruments used to transfer credit risk were significantly increased. There are a number of factors (external and internal) that can lead to the appearance of credit risk. Within the external factors there are economic situation, natural circumstances and etc., but when we analyze the internal factors focus is on bank philosophy management. It should be noted that bank management should have a special focus on internal factors.

Because of the large importance of credit risk, priority is to determine a bank's ability to adequately identify, evaluate and to respond with active measures to the credit risk. In order to minimize the impact of bank credit risk, it has to find sources of its creation. Accordingly, it is necessary to ensure maximum professionalism in all phases of the lending to avoid granting loans to those clients who are suspected that will not be able to pay back the loan on time.

Literature Review

In modern banking business conditions there are numerous risks that challenge the individual banking business, fee or, in the extreme case, a change that affects the increase of uncertainties the outcome of the transaction, and increases the uncertainty of earning income of the bank (Cvetinović, 2008). In addition to the risks affecting the business of banks, for which is necessary to identify all approaches to measurement, and evaluation and management, we include the risks that may result from inadequate management of information and associated technologies.

According to Hadžić (2008) the banking sector is inevitable and certainly the most important part of the market economy, and it is therefore necessary to regulate certain laws, financial systems and various state regulations. Exposure to large risks creates a problem for the banking business because market mechanisms are not able to remove them, and under banking regulations it is considered state interference in business operations of banks.

Banks profitability is based on low tasks and low regulation. Because of approving risky loans banks are recognized as the main drivers of global economic and financial crisis. Risk-taking as well as its presence in the banking sector, can not be completely removed. The complete abolition of the risks of failure of business in the banking industry leads to the disappearance of the reasons for the existence banking industry.

The need for regulation and supervision of the banking sector lies in its importance in a market economy because the banks are actually one of the main financial distributor. Stable and efficient banking sector affect the economic growth of a country and as a starting sentence of a successful business bank said generated public confidence (Hadžić, 2008).

Latković (2002) states that risk management is a function of buying insurance, or the estimate, control and funding exposure to certain types of losses. Each resource of bank may be exposed to certain risks which will have a negative impact on the operations of banks (Cvetinović, 2008). On this basis, there is a need of banks to manage these risks in order to eliminate completely or mitigated their effects. However, given the close connection of all risks facing the bank is impossible to define the boundaries of the termination of one type of risk and onset of action of another kind.

The credit risk of banks consists in the likelihood that borrowers do not return the loans on maturity together with accrued interest. Failure to return the bank loan together with interest represents a loss for the bank. Therefore, the bank must in approving the loans take account of minimizing credit risk. Credit risk management should enable the bank to cover normal losses from formal reserves. Vento & Ganga (2009) demostrated several examples; if the bank losses, due to the presence of credit risk, were greater than the formal reserves, then it would be covered from the share capital of the bank. In case that the cumulative losses of banks are very high, the bank

would not be able to cover them from the resources of available capital. In that case, the bank became insolvent.

Also, the literature mentions another aspect of determining the structure of credit risk (Table 1) as well as the funding arrangements.

Table 1: Structure of Credit Risk

Expected loss **Losses that must be assumed that will be created on an ongoing basis as a result of certain operations.**	Costs (covered from the income of the bank)
Unexpected loss **Unusual, though predictable losses that banks should be able to absorb in normal course of business.**	Risk capital
Stress loss **Possible - but unpredictable - had extremely scenario that the bank must be able to survive.**	The limits (risk-bearing capacity / protection through limit concentration)

Source: Ćirović, 2006

In the modern banking the concept of credit risk is widened. In fact, it is not considered that credit risk consist solely in the fact that the borrower does not perform regular servicing its financial obligations under a credit agreement with the bank. It si very important to have approach for Credit Risk Assesment (CRA) because of this largely depends the success of financial institutions.

Credit risk or counterparty risk is defined as the probability that a borrower or issuer of a financial asset would not be able to pay interest or repay the principal according to the terms set forth in the Credit Facility Agreement. We can say that the credit risk is an integral part of the banking business. Credit risk means that the payment can delay or ultimately not achieve what may cause problems in cash flow and affect on the liquidity of banks (Greuning, 2006).

Because of the significance of the impact of credit risk it is important to conduct a comprehensive assessment of the Bank's assessment, guidance, supervision, approval and collection of loans, guarantees and other credit assets. Total Credit Risk Management test includes an evaluation of policies and practices of credit risk management of banks. This assessment should determine the adequacy of the received financial records of borrowers or issuers of financial instruments which the bank has used as a basis for investing in the same financial menahizam or loan and periodic evaluation of profits already accepted risks of the bank.

Research question/hypothesis

The following is the basic question of research paper: „*Why is an adequate analysis of the legal entites in banking significant?*"

The main hypothesis is defined as follows:

„*Adequate analysis of legal entities and self-rating as internal ratings are a function of NPLs.*"

The additional hypothesis states:

„*Internal models assessment of clients may have potential weakness because of subjectivity entities who deal with assessment and require training to operators and employees in the banking sector.*"

The Bank operates under modern conditions in the environment of other banks, customers and the economy as a whole, which introduces an element of risk in the banking business. Risks that each bank faces are inevitable and must be assessed, controlled and financially neutralized so as not to jeopardize a whole business of any bank. Risk management in the banking industry has two main objectives. The first objective is to avoid the insolvency of banks, especially bearing in mind the changed macroeconomic and institutional environment in which banks operate in the

current stage of development. In this changed environment, the credit and market risks are significantly increased compared to the risks that existed in the traditional setting of banks. Due to increased competition, changed positions in bank solvency can be achieved much more quickly than in the past. Other risk management objective is to maximize the rate of return on equity adjusted for risk. Namely, if the bank risks were underestimated, it would have a negative effect on the profitability of banks because the actual losses brought down the rate of return on equity below the expected level.

As already mentioned in the previous sections of this work paper, credit risk is a special type of risk to which the bank faces when the client is unable to fulfil the obligation in part or in full, which will affect the bank to suffer financial loss. However, in order to protect the bank against this risk it is before concluding the contract obliged to assess the borrower's creditworthiness and the quality, marketability, availability and value of collateral of receivables.

Therefore, the objective assessment of creditworthiness is actually determining credit risk. It is extremely important that Vakufska bank perform a credit analysis during the assessment of the creditworthiness of legal entities. During the credit analysis, special attention is paid to qualitative and quantitative analysis, collateral, 5C analysis as well as exposure relating to internal and regulatory limits. And at the same, it is clear that an adequate analysis of the legal entities and self-rating as a function of internal rating NPL. Also, what you need to say is that a special role in the assessment of credit risks are the Risk Management Department, Vakufska Bank noted in its analysis of all the factors that influence the decision on the creditworthiness of the client but also ultimately to the bank's business and that is why employees in sectors and departments directly involved in credit analysis must approach all the necessary training to be able to do their job in accordance with all the internal documents of the bank.

Methodology

Taking into account the specificities of the research problem and theoretical approach to this issue, as well as available data in the field of banking, and credit risk management, it will be used the following research methods:

1. The basic method of scientific research was selected method of incomplete induction as the most appropriate, and it will be combined with other methods of scientific research;

2. Method of analysis will parsed the complex concepts, reasoning and conclusions on their simpler components and elements. Methods of classification and comparison will be applied on them in order to continue using the method of abstraction could separate the essential from the non-essential elements;

3. Deductive method presupposes knowledge of general attitudes, principles, having a general knowledge on the basis of which is understood something special or individually. The deduction is usually based on general truth and come up with specific and individual knowledge. The most important elements of deductive methods are methods of analysis, synthesis, abstraction, generalization and abstraction, generalization and specialization.

4. In the parts of the final paper, where is not possible to apply the above scientific methods it will be applied method of description, which means it will be easy to describe and state the facts, phenomena and processes, and the observation confirmed the relationships and connections.

Data presented in the paper are collected from various sources including:

a. books from the banking;

b. BA, MA and PhD theses;

c. sources from the Internet (databases, articles and studies and etc.).

Results

Almost every financial institution around the world has their business performance measured in customer satisfaction, employee satisfaction and financial results. The financial result, as seen through the prism of profitability, has special significance, in essence it means growth in the value of share capital of the bank. In order to survive and raise its value, the bank has to develop, to have more customers, to develop their products and services to emerge on the market, to collect more funds, to place more funds as well as introducing technology into their business and FIG. To achieve all this, banks are often faced with many obstacles and risks.

Credit risk is one of the most important risks that banks face, as a credit transaction represents, for each commercial bank, an active basic banking business. When it comes to the risk of loan repayment and the interest earned, it can be about the risk that the entire amount of the claim to be called into question at a particular time or only part of it. If this happens in a lot of cases, or with multiple customers, then the bank can get in the danger zone of insolvency.

A Legal entity has legal rights and obligations. It has the ability to make a contract, to sue and to be sued. This person is usually recognized as an organization, company or government made up of several persons who, in accordance with the law, are treated as one. Banks are so arranged as to have sectors whose jobs include Corporate Banking and Retail Banking. In the course of their cooperation Bank assesses the credit quality of all legal entities who are their clients and who apply for loans. Determination of creditworthiness relates to the assessment of the financial capacity of the borrower to repay the loan (credit) as well as to pay interest that are part of the loan. Also, in addition to evaluate the creditworthiness, Bank conducts credit analysis, through which determines the likelihood of repayment obligations under the loan received from the client.

A key role in assessing the credit-worthiness of legal entity, are sectors of the payment system or service for credit risk management. As part of its assessment of creditworthiness, the service takes into account all qualitative and quantitative indicators, cash flows, as well as purpose of loans (financing) and the 5C analysis and exposure analysis.

Within the assessment of the creditworthiness, a bank must keep in mind that the legal entity has the ability to promptly and fully carry out the repayment of debt of the primary sources. In terms of primary sources include the cash provided from operating activities and other debtors. Whether the bank will approve the loan depends on whether the client has fulfilled all the criteria that the bank established its internal regulation, and minimum requirements relating to the assessment of creditworthiness.

Conclusion

In course of business, banks face a number of risks that could affect the outcome of business. The risk can be tangible or intangible. Physical risk is a risk that is reflected in the possibility of losing the transaction, client or business. Immaterial risk is the possibility, with uncertain probability, that there may be tarnishing the reputation of the bank, which is the key to confidence in individual banks and whose violation may endanger its entire business. For operational risk in banks is characteristic that the risk is expressed in money terms regardless of the type of risk in question.

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self-rating as a function of internal rating NPL. Also, what you need to say is that a special role in the assessment of credit risks are the Risk Management Department, Vakufska Bank noted in its analysis of all the factors that influence the decision on the creditworthiness of the client but also ultimately to the bank's business and that is why employees in sectors and departments directly involved in credit analysis must approach all the necessary training to be able to do their job in accordance with all the internal documents of the bank.

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Анализ кредитного риска юридических лиц на примере "Vakufska Banka" – Сараево

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Аннотация. В своей деятельности банк сталкивается с многочисленными явлениями, которые могут привести к негативным последствиям. Риск представляет собой неопределенность будущих результатов, которая состоит из неопределенности и воздействия указанного неопределенности. Если банк сталкивается с неопределенностью - это может привести к серьезным финансовым последствиям, при условии, что уровень неопределенности не приравнивается к степени воздействия. Следует отметить, что большинство из рисков не могут быть предсказаны и финансовые учреждения снова и снова будут сталкиваться с ними в связи с тем, что не предпринимают сопровождающих мер и не разрабатывают стратегии по борьбе с рисками. Предметом исследования является определение и анализ управления кредитным риском. В соответствии с предметом исследования, к основным целям можно отнести следующие: определить основные банковские риски, а также базельские принципы и стратегии управления рисками, определить кредитные риски, представить анализ управления кредитными рисками у юридических лиц в банковской сфере в настоящее время на примере "Vakufska banka" (анализ качественных и количественных показателей, анализ денежных потоков, анализ проектов, анализ цепочки поставок, воздействие, анализ взаимосвязей).
Классификационные коды JEL: G2, G1.
Ключевые слова: управление рисками, юридические лица, кредитный риск, банковское дело.